



ESMA opinion on good practices on governance arrangements for structured retail products. July 2014.

ESMA has published, on the 27th March, a **review of certain aspects linked to the manufacturing and distribution of retail structured products or structured retail products** (hereinafter SRPs). ESMA's competence to deliver opinions to competent authorities is based on article 29.1.a) of the Regulation No 1095/2010 (the ESMA Regulation).

ESMA opinion takes into account relevant work done in this field both at European and international level. IOSCO has launched a consultation and a final report on the regulation of SRPs (2013), and the ESMA Committee on Economic and Market Analysis (Committee for Economic and Market Analysis (CEMA) published, in July 2013, an economic report on complex financial products sales to retail investors in the EU, a phenomenon called retailisation. (See previous editions of the International Bulletin.)

In 2013, ESMA mapped the measures adopted in the Member States in relation the issuance and distribution of the SRPs. As a result of the review of the information obtained, ESMA has developed a broad set of non-exhaustive of **examples of good practices** (attached as Annex 1 hereto) illustrating arrangements that investment firms -taking into account the nature, scale and complexity of their business- could put in place to improve investor protection regarding, in particular, (i) the complexity of the SRPs they manufacture or distribute, (ii) the nature and range of the investment services and activities undertaken in the course of that business, and (iii) the type of investors they target. These good practices should also be a useful tool for competent authorities in carrying out their supervisory action.

ESMA's opinion is:

- ESMA considers that sound product governance arrangements (defined as policies, procedures, systems and controls established by an investment firm) on SRPs are fundamental for investor protection purposes, and can reduce the need for product intervention actions by competent authorities.
- ESMA considers that, when supervising firms manufacturing or distributing and SRPs, competent authorities should promote, in their supervisory approaches, the examples of good practices for firms set out in annex 1 hereto.
- ESMA considers that, although the good practices set out in Annex 1 hereto focus on SRPs, they may also be a relevant reference for other types of financial instruments (such as asset-backed securities or contingent convertible bonds), as well as when financial instruments are being sold to professional clients.
- ESMA clarifies that exposure to risk is an intrinsic feature of investment products. The good practices set out in annex 1 refer to product governance arrangements and do not (and cannot) aim

at removing investment risk from products.

For the purposes of these good practices, **SRPs** are compound financial instruments that combine a base instrument with an embedded derivative that provides economic exposure to reference assets, indices or portfolios so that investor redemptions are linked to the performance of these assets, indices or portfolios.

Annex 1 describes, as it has been said above, a set of **examples of good practices** for investment firms manufacturing and/or distributing SRPs. It is good practice that these firms adopt sound formal **product governance arrangements** that address any potential source of investor detriment and ensure that due consideration is given to the interest of investors during each stage of the life of an SRP (origination, launch, distribution and redemption).

Firms solely distributing SRPs hold also a clear responsibility towards investors. When a firm distributes a SRP manufactured by a firm not subject to MiFID, it is good practice to take all reasonable measures to verify that the manufacturer of that SRP ensures a level of protection of investors' interests similar to the one promoted by the good practices included in this Annex 1.

Governance arrangements should be transparent, consistent and auditable, and include the following key features: 1) steps that have to be followed before the manufacturing and/or distributing, and description of the records about critical elements of the arrangements; 2) roles, powers and responsibilities of the staff involved in the manufacturing and /or distribution of SRPs; 3) assumption of responsibility by senior management; 4) no over reliance on the judgment and discretion of a limited number of individuals but all relevant staff; 5) subject to appropriate controls, including the compliance function ; and 6) review and update of governance arrangements on a regular basis, including analysis of relevant information such as complaints or investor surveys.

It is good practice that, depending on their role (manufacturing and /or distributing), firms governance arrangements cover the following areas:

.- Product design

It is good practice for manufacturers (firms that issue, develop and design SRPs): (i) to ensure they meet the financial needs, investment objectives, knowledge and experience of the target market identified, (ii) to consider the best interest of investors, avoid conflicts of interest and conduct an appropriate and reasonable due diligence on third parties involved in the issuance of SRPs, and (iii) to use tests to price and evaluate the SRP and fix the risk/reward of the market to which it is addressed.

It is considered good practice that the issuer provides the distributor with the key information about the SRP (pay-off design, expected returns and risks including the potential loss of all or part of the capital invested).

.- Product Testing

It is good practice for manufacturers to back test the SRP and to undertake simulations of future performance scenarios to assess whether likely outcomes of the SRP would meet the investment objectives of target market. It is good practice for testing also to consider extreme economic environments (stress testing) and quantitative assessments of external risks.

It is good practice for distributors to examine critically the results and scenarios of issuer's tests.

.- Target market

It is good practice for manufacturers and distributors of SRP the appropriate identification of the potential target market. For distributors, the analysis of the characteristics of the target market does not replace the assessment of suitability to be carried according to MiFID requirements. An analysis of the charging structure

is also recommended to assess if it could meet the demands and objectives of the target market.

.- Distribution strategy

It is good practice for manufacturers and distributors to put investors' best interest first in their distribution strategy. This implies taking appropriately into account potential risk arising from the way they distribute (directly or indirectly) SRPs. If manufacturers distribute their SRPs through other firms, they should adopt appropriate policies and procedures regarding their relationships with those firms.

It is good practice that distributors require sufficient information from manufacturers, in order to be able to adequately train their staff and to conduct their own analysis of the SRP. Also, distributors will check if the advertising material provided by the manufacturer is easily understood by investors and/or if additional information is required.

It is good practice for both manufacturers and distributors to ensure compliance with the MiFID remuneration guidelines.

.- Value at the date of issuance and transparency costs

It is good practice for manufacturers to establish the value (at the date of issuance) of the SRPs and to make available, directly or indirectly, to retail investors. The value is determined in accordance with the methodologies used in the design and testing of the SRP and as well as with the ones used by the manufacturer to value its own proprietary portfolio. Generally accepted standards will be used, for example, IFRS 13 according to which "fair value" of a SPR is the price that would be received to sell an asset or to transfer a liability in an orderly transaction between market participants at the measurement date excluding costs. Another option would be to use the concept of "intrinsic value" that sums all components of the transaction including estimated costs and fees.

.- Secondary market and redemption

It is good practice for firms to offer exit opportunities to investors who may need to sell the SRP before its end term and disclose those opportunities appropriately to the investors. Exit prices will be determined using objective and predefined methodologies of which investors should be informed in advance.

When the SRP trade on a secondary market (other than a regulated market), it is good practice that firms adopt policies and procedures identifying and managing all relevant risks linked to trading on that secondary market. Distributors will disclose the conditions appropriately trading conditions, methods of pricing and potential costs associated with transactions.

It is also good practice to inform of the redemption conditions in a timely manner to investors prior to the SRP maturity and of the different reinvestment options offered to them.

.- Review process

It is good practice for manufacturers to periodically gather information about the SRP in order to improve the design of the SRP, to better adapt to the needs of the target market and to improve the firm's product governance arrangements. If there is a significant difference between actual and expected performance of the SRP, firms will consider what actions could be taken to mitigate detriment to investors.

If you want to read the opinion of ESMA on good practices for governance arrangements for structured retail products, please, click on: http://www.esma.europa.eu/system/files/2014-332_esma_opinion_structured_retail_products_-_good_practices_for_product_governance_arrangements.pdf

If you want to read ESMA Opinion on MiFID practices for firms selling complex products, please, click on: http://www.esma.europa.eu/system/files/ipisc_complex_products_-_opinion_20140105.pdf

If you want to read the IOSCO consultation paper on the regulation of retail structured products, please, click on: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD410.pdf>

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